COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, JULY 26, 2000

APPLICATION OF

THE POTOMAC EDISON COMPANY
d/b/a ALLEGHENY POWER CASE NO. PUE000280

ORDER APPROVING ELIMINATION OF FUEL FACTOR
AND ESTABLISHING CAPPED RATES

On May 25, 2000, The Potomac Edison Company, d/b/a Allegheny Power ("AP" or "Company") filed an application, pursuant to §§ 56-77, 56-90, 56-88.1 (to the extent this provision is applicable), and 56-590 B of the Code of Virginia, for approval of a plan (the "Plan") for the functional separation of its generating assets from its transmission and distribution assets, as required by the Virginia Electric Utility Restructuring Act (the "Act").

In the application, AP proposed to separate its generation facilities from its transmission and distribution facilities by transferring its generating assets, certain utility securities, and certain contractual entitlements to generation to an affiliate called "GENCO," which would own and operate the generation facilities.

On July 11, 2000, we entered our Order Approving Phase I Transfers, granting AP the authority to make the requested asset transfers, subject to the terms of the Memorandum of

Understanding ("MOU"), as supplemented, negotiated between itself and the Commission Staff. The Order continued the matters for further proceedings, including the hearing established in our June 9, 2000, Order for Notice and Comment, in which consideration of the elimination of the Company's fuel factor recovery mechanism, proposed in the MOU, was to be given.

The MOU contained certain representations and undertakings that AP has made in order to comply with the requirements of the Act. The Company agreed to make a base rate reduction to its Virginia customers of $1 million annually, effective July 1, 2000, with the reduction applied ratably to each rate classification. Further, AP agreed not to file an application for a base rate increase prior to January 1, 2001.

AP also agreed to operate and maintain its distribution system in Virginia at or above historic levels of service quality and reliability, and to implement timely distribution system improvements needed to maintain the quality of its service. During periods when AP will provide default service as provided by the Act, it will contract for generation services for default service customers at the same cost that it would incur to serve customers from the units it now owns, but seeks to divest to GENCO under the Plan.

The final aspect of the MOU involved modification to the manner in which the Company recovers its fuel costs. AP

proposed to terminate its fuel factor cost recovery mechanism beginning July 1, 2000, and instead recover fuel costs in base rates. The Company and Staff agreed in the MOU that costs now recovered through the Company's current fuel factor should be rolled into the base rates at an effective rate of 1.181cents/kWh.

Section 56-249.6 of the Code of Virginia ("Code") provides that the Commission may dispense with the fuel cost recovery mechanism only "after notice and hearing" and finding that the electric utility's fuel costs "can be reasonably recovered through the rates and charges" established in accordance with other provisions of law. Accordingly, we established a public hearing to receive evidence and argument on this aspect of the Plan, separating our consideration of the proposed Phase I transfers from our consideration of the cost issues associated with the proposed elimination of the fuel factor.

On June 30, 2000, the Commission Staff filed its Report explaining the basis for re-setting base rates to include fuel cost recovery at the effective rate of 1.181 cents/kWh as contained in the MOU. Comments in this docket were filed on June 30 by the Office of Attorney General, Division of Consumer Counsel ("Consumer Counsel") and Virginia Electric and Power Company ("Virginia Power"). The Company filed the rebuttal testimony of its witness Steve L. Klick on July 17, 2000.

Virginia Power filed comments on the Staff Report on July 17, 2000, and clarified its comments by a filing on July 20, 2000.

The fuel factor mechanism established by § 56-249.6 of the Code of Virginia operates to permit utilities to recover prudent fuel expenses on a dollar-for-dollar basis. Fuel expense is the largest single cost for electric utilities. In 1999, the General Assembly enacted the Virginia Electric Utility Restructuring Act, Code §§ 56-576 et seq. (the "Act"). Section 56-582 acts to "cap" the rates utilities can charge during a period that may extend to July 1, 2007. The Act permits these rates, however, to continue to be modified by the application of the fuel factor during this period.

By asking that we eliminate its fuel factor mechanism, AP abandons the protection otherwise available to it under the Code and instead assumes the risk that it can recover its fuel expenses under the capped rate alone during this period of transition to a competitive market. Rates established to include the costs otherwise recovered through the fuel factor will be capped until perhaps 2007.

The Staff Report advises that the proposed fuel recovery level, the equivalent of a 1.181 cents/kWh fuel factor, "exceeds the latest twelve-month actual fuel cost by only about one-half

mill and the projected fuel cost by one mill."[1] A "mill" is one one-tenth of a penny. We find that rates established to recover this level of fuel expenses will be just and reasonable for application during the capped rate period.

During the course of these proceedings, the Company has concluded two separate agreements with the Office of the Attorney General, Division of Consumer Counsel ("Consumer Counsel"). In the first, appended as a Stipulation to comments filed by the Consumer Counsel on June 30, 2000, the Company agreed that it would not apply wires charges, also permitted under the Act, to the bills of any of its customers that obtain power from another supplier during the rate cap period.

The second agreement between AP and Consumer Counsel, in which the Commission Staff concurred, operates to mitigate the effect of the slightly higher fuel cost recovery that would accrue from the elimination of the fuel factor and recovery of the expense in base rates. In the first year following adoption of the new rates, the Company would credit customer bills in the aggregate amount of $750,000. In the second year, the credit would drop to $250,000. In the third year and after, there would be no credit. This agreement was filed in the form of a Motion to Expand Settlement on July 19, 2000.

[1] Staff Report at 7.

NOW THE COMMISSION, having considered the Application, the MOU, the supplements thereto, the Comments of the parties, the Staff Report and the evidence of record, is of the opinion and finds that the proposed elimination of the fuel factor is in the public interest and should be adopted. We find, as required by § 56-249.6 of the Code of Virginia, that the Company's fuel expenses can reasonably be recovered without resort to the fuel factor mechanism permitted therein and that the mechanism can, and should, be dispensed with. We further find that the rates established as proposed in the MOU are just and reasonable and constitute the Company's capped rates. Further, we find that the Motion to Expand Settlement is reasonable and should be granted. We find that the Stipulation is reasonable and should be adopted.

Accordingly, IT IS ORDERED THAT:

(1) The Motion to Expand Settlement is granted.

(2) The Stipulation is adopted and the Company will not impose any wires charges during the capped rate period.

(3) The fuel factor for Allegheny Power is dispensed with and the Company shall file forthwith tariffs containing rates designed to recover its fuel expenses, at the equivalent rate of 1.181 cents/kWh, effective for bills rendered on and after August 7, 2000. The tariffs shall also reflect the $1,000,000 annual base rate reduction contained in the MOU and approved

hereby. Rates thus tariffed shall be capped as provided by the Act.

(4) The Company shall file forthwith tariffs setting out the credit to be applied to customer bills in the aggregate amounts set out herein during the first two years following the effective date of the rates established herein.

(5) This matter is continued for further orders of the Commission.